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Private information, institutional distance, and the failure of cross-border acquisitions: Evidence from the banking sector in Central and Eastern Europe☆

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ABSTRACT

In this paper, we develop an information theory-based framework about cross-border acquisitions in the financial intermediation industry. We argue that even though "soft" information embedded in customer relationships of local banks can, in principle, help multinational banks (MNBs) overcome informational disadvantage in host countries, the cost of verification of this private information may, paradoxically, make local banks with significant customer relationships unattractive for cross-border acquisition. Further, we propose that the relationship between the amount of customer information embedded in an incumbent bank and the likelihood of its acquisition by a MNB is modified by the institutional distance between the home and host countries of the MNB. Specifically, the strength of the negative relationship increases with institutional distance between home and host countries because the verification cost of private information increases with institutional distance. Our hypotheses find support in the context of Central and Eastern Europe.

1. Introduction

A fundamental characteristic of the financial intermediation industry is the pervasive informational asymmetry that exists between banks and potential borrowers (Brealey, LeLand, & Pyle, 1977; Bhattacharya & Thakor, 1993; Freixas & Rochet, 2008). The consequences of this information asymmetry and the associated adverse selection problem for credit market failures are much discussed and well documented (Stiglitz & Weiss, 1981; Williamson, 1986, 1987; Berger & Udell, 1998). It follows, therefore, that mechanisms that help ameliorate the informational asymmetry problem are beneficial for both the financial intermediaries (in the vast majority of cases, banks) and borrowers. Consequently, there is a large discussion of the use of collateral and relationship banking, mechanisms that help avert credit market failures, in the financial intermediation literature (Besanko & Thakor, 1987; Bester, 1987; Boot, 2000; Berger, Frame, & Ioannidou, 2011; Degryse & Van Cayseele, 2000).

Relationship banking, in particular, is viewed as a widely used mechanism to overcome the problem of information asymmetry. As argued by Berger and Udell (2002, F32), it facilitates "accumulation over time by the loan officer [of a bank] of 'soft' information" about potential borrowers. While such a relationship can be mixed blessing for the borrowers who may have greater access to external finance but at a higher cost (Greenbaum, Kanatas, & Venezia, 1989; Petersen & Rajan, 1994; Schenone, 2010; Bolton, Freixas, Gambacorta, & Mistrulli, 2016), largely because it ensures that banks have monopoly over the information about the borrowers with whom they have such relationships, it has been argued that relationship banking can be the source of competitive advantage for banks (Keltner, 1995). This is consistent with a wider, albeit underdeveloped, literature about the ability to reduce information costs – in the presence of informational asymmetry – as a source of competitive advantage (Nayyar, 1990). It is also consistent

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with the broader argument that resources such as information about borrowers (henceforth, interchangeably called *customers*), especially "soft" information, is not easily imitable outside a bank with which a set of customers have a relationship and that, therefore, such information can be a source of competitive advantage (Barney, Wright, & Ketchen, 2001; Miller, 2003). Indeed, it has been argued that the risk of adverse selection in credit markets that is experienced by new banks can act as an entry barrier in the banking industry (Dell'Ariccia, Friedman, & Marquez, 1999; Dell'Arricia, 2001), i.e., private information about the borrowers give the incumbent banks competitive advantage.

This has two implications for the international business literature. To begin with, when a multinational bank (MNB) enters a new country, informational asymmetry with local borrowers will put it at a competitive disadvantage vis-à-vis incumbent banks.[2] A MNB, therefore, is at an informational disadvantage in a host country, especially in emerging economy contexts where public sources of information such as credit history records are often incomplete or altogether unavailable, and where the options to screen potential customers by way of mechanisms such as externally assigned credit ratings are restricted or altogether absent. This disadvantage can force MNBs to focus mostly or entirely on clients about whom information is relatively easily available, namely, multinational enterprises (MNEs) from the home countries of the MNBs and large (or blue chip) domestic firms (Miller & Parkhe, 1998; Mutinelli & Piscitello, 2001; Mian, 2006; Berger, Klapper, Peria, & Zaidi, 2008). This restriction, in turn, makes it difficult for MNBs to grow their businesses significantly in the host country. Berger et al. (2008) demonstrate this in the context of India, where foreign banks operate on their own through branches and wholly-owned subsidiaries, and account for less than 10 percent of both the deposit and credit markets even after more than 20 years of banking sector reforms.

A MNB can use acquisition of a local bank, in which information about a pool of local borrowers are embedded by way of existing customer relationships, to overcome this disadvantage.[3] Evidence suggests that the information embedded within customer relationships can be particularly valuable in contexts characterised by economic flux and crises (Ferri, Kang, & Kim, 2001; Banerjee, Gambacorta, & Sette, 2017). However, in choosing the acquisition of an incumbent bank, the MNB would trade one form of informational asymmetry for another. Specifically, while the acquired incumbent bank may have "soft" information that helps reduce informational asymmetry with local customers, the MNB may not be privy to this information prior to the acquisition. The MNB would, therefore, have to strike a balance between the advantages associated with access to the customer information embedded in incumbent banks (especially the "soft" information) and the risks associated with acquiring an incumbent bank that may not – indeed, by very nature of "soft" information, perhaps cannot – share this information prior to the acquisition. Alternatively, as argued in the information economics literature, which eschews a binary can-cannot distinction in favour of a discussion about the cost of verification of the nature and quality of information, the MNB's ability to verify the nature and quality of the private ("soft") information about customer relationships embedded in incumbent banks can be fairly high before the incumbent bank is actually acquired.

In this paper, we contribute to the theory of strategic decisions about cross-border acquisitions, extending a relatively small literature (Chari & Chang, 2009; Dikova, Rao Sahib, & van Witteloostujin, 2010; Cuypers, Ertug, & Hennart, 2015), and develop an information theory-based framework specifically about the financial intermediation industry. We also add to the relatively small literature on strategic decisions of companies when their acquisition targets – more broadly, counterparties – have private information (Capron & Shen, 2007; Dushnitsky & Shaver, 2009). Specifically, we bring together two different strands of the literature, namely, the literature on market failure in the presence of information asymmetry which has wide-ranging applications (Akerlof, 1970), and that on institutional distance that has implications for strategic decisions in international business (Xu & Shenkar, 2002; Eden & Miller, 2004; Gaur & Lu, 2007). To be fair, our conceptual framework has greater relevance for MNB decisions to acquire local banks in emerging economy contexts where markets for information are highly imperfect. However, the basic reasoning has much wider implications.

We propose that the informational asymmetry about the nature and quality of these customer relationships, and the attendant risk of adverse selection, would result in a negative relationship between the amount of customer relationship embedded in an incumbent bank and the likelihood of its acquisition by a MNB. Given the importance of this embedded customer information for competitive advantage in the banking industry, this is apparently paradoxical but, as in the case of Dushnitsky and Shaver's (2009) study of firms' (un)willingness to accept investment from corporate venture capital firms belonging to the same industry, entirely logical.[4] Further, we propose that the relationship between the amount of customer information embedded in an incumbent bank and the likelihood of its acquisition by a MNB is moderated by the institutional distance between the home and host countries of the MNB. Specifically, the strength of the aforementioned negative relationship increases with institutional distance between home and host countries as the verification cost of private information embedded in incumbent banks increases with institutional distance. The propositions (or hypotheses) are tested using data on acquisition of local banks by MNBs in the Central and Eastern European (CEE) context, and the empirical results support the hypotheses.

2. Hypotheses development

To reiterate the problem of a MNB, it can enhance its competitiveness in a host country market if it gains access to the private information about potential borrowers/customers that are embedded in bank-customer relationships in the incumbent banks. The MNB can get access to the headline information such as the amount and tenor of loans (and perhaps even details about repayment terms and covenants) associated with each of these relationships, by acquiring a local bank, and access to such hard information is generally available during the customary due diligence process prior to the acquisition. However, it may not get all the relevant information about the nature of these relationships that are necessary to fully (at least, sufficiently) understand the credit

[2] In some sense, a MNB entering a host country suffers from the "liability of outsidership" (Johanson & Vahlne, 2009) because it is not part of the bank-client network. The MNB has to overcome this liability not so much through "trust-building and knowledge creation", as in Johanson and Vahlne's (2009) paradigm, but through relationship-building that helps them overcome their information asymmetry vis-à-vis their customers. (Note that we deliberately use the phrase "liability of outsidership", as opposed to "liability of foreignness" that is used in discussions about internationalisation, largely because, as mentioned earlier, the problem of access to private information of customers can also pose an entry barrier for domestic entrants to the market for financial intermediation.)

[3] A perusal of the literature on internationalisation of banks suggests that de facto the acquisition of a local (or host country) bank may be the only choice available to a MNB other than a Greenfield entry, for a variety of factors such as the absence of robust and financially viable host country partners (see, for example, Bonin, Mizsei, Szekely, & Wachtel, 1998). Indeed, available data suggests that foreign bank entry in Central and Eastern Europe (CEE) during the first decade and a half of transition were almost entirely greenfield entry as subsidiaries/branches or involved cross-border acquisitions (e.g., Claeys & Hainz, 2006; Hryckiewicz & Kowaleski, 2008). In other words, access to private information about local customers in a host country may not be accessible by alternative means such as a joint venture (JV) arrangement with a local bank. While this is not germane to the narrative of the paper, which is not about entry mode choice of MNBs, it is nevertheless an interesting observation that underlines the importance of acquisitions in the process of internationalisation of MNBs.

[4] The key difference between intuition for the paradox discussed in Dushnitsky and Shaver's (2009) paper and that of ours is that moral hazard lies at the heart of the mechanism that explains their paradox while, as mentioned above, the lemons problem (or adverse selection) lies at the heart of ours. However, both moral hazard and adverse selection follow from informational asymmetry between two transacting parties.